DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS: 02-0512
Indiana Gross Retail Tax
For the Years 1994 through 2000

NOTICE: Under IC 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of the document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUES

I. Gross Retail Tax Assessment.

Authority: IC 6-2.5-2-1(a); IC 6-2.5-2-1(b); IC 6-2.5-9-3; IC 6-8.1-5-1(a); IC 6-8.1-5-1(b); 45 IAC 2.2-6-8(a).

Taxpayer maintains that for purposes of determining taxpayer's gross retail (sales) tax liability, the Department of Revenue (Department) overestimated the total amount of taxpayer's gross retail sales.

II. Abatement of Penalty.

Authority: IC 6-8.1-10-2.1; IC 6-8.1-10-4(a); 45 IAC 15-5-7(f)(3); 45 IAC 15-11-2(b).

Taxpayer asks that the Department exercise its discretion to abate the 100 percent fraud penalty assessed at the time of the original audit examination.

STATEMENT OF FACTS

Taxpayer is a company in the business of manufacturing and selling candy at retail. Taxpayer states that it has been in business since 1994. During 2001 and 2002, the Department conducted an audit review of taxpayer's business records and tax returns. As a result of that review, the Department determined that taxpayer underpaid the amount of sales tax due to the state. Accordingly, the Department imposed an assessment of additional sales tax for the years at issue. Taxpayer disagreed with the audit's methodology and conclusions and submitted a protest to that effect. An administrative hearing was conducted during which taxpayer further explained the basis for its protest. This Letter of Findings results.

DISCUSSION

I. Gross Retail Tax Assessment.

Taxpayer makes retail sales of candy from multiple locations. The Department determined that during 1994 through 1998, taxpayer failed to maintain records sufficient to adequately document

the total amount of its gross retail sales. Therefore, the Department calculated the taxpayer's gross retail sales based upon the best information available.

For 1994 and 1995, the audit relied upon a federal Revenue Agent Report (RAR) containing IRS determinations, findings, and adjustments for those years. The RAR calculated taxpayer's income by multiplying taxpayer's production costs by 1.5. For example, if taxpayer spent $100 producing candy during a certain time, the RAR concluded that taxpayer received $150 as income when it sold the candy. For those years in which it was possible to determine gross sales based upon the taxpayer's own records, the audit relied on those records and did not use the 1.5 multiplier.

Taxpayer disagreed with the audit's methodology and the determinations as to the total amount of taxable gross receipts. Taxpayer produced records which purported to establish a lesser amount of gross receipts. In addition, taxpayer maintained that the federal RAR itself was factually flawed and that the Department's conclusions – in which it relied upon that report – were unwarranted.

Taxpayer maintained that the audit's reliance on the 1.5 multiplier resulted in an overstatement of its gross annual receipts. Taxpayer asserted that the 1.5 multiplier did not take into account candy which was spoiled, lost, or which was given away. In addition, taxpayer believes that the audit's determination did not take into consideration infusions of cash which were made into the business. According to taxpayer, because its business obtained unrefunded cash investments, the business was able to pay for productions costs such that the production of the candy did not necessarily result in corresponding gross receipts.

In addition, taxpayer challenges the audit's conclusion as the amount of its taxable gross receipts because the audit failed to take into account the seasonal nature of taxpayer's business and the difference in sales which were attributable to the various retail locations.

In summary, taxpayer's maintains that the assessment of sales tax is incorrect because the audit did not rely on the best information available.

In reviewing the taxpayer's records, the audit found that records of sales receipts were incomplete. In 1995, the audit found that the sales invoices were unavailable for approximately 90 percent of the year. For 1996, sales invoices were unavailable for approximately 94 percent of the time. In 1997, sales invoices were unavailable for the entire year. In contrast, taxpayer's actual invoices for 2000 indicated that it had approximately $7,000 in sales; however, for that same period, taxpayer paid sales tax based upon approximately $15,000 in gross sales. The audit documented similar disparities for each of the remaining years considered during the audit.

IC 6-2.5-2-1(a) imposes an "excise tax, known as the state gross retail tax . . . on retail transactions made in Indiana." The person who buys tangible personal property in a retail transaction is responsible for the tax and "pay[s] the tax to the retail merchant as a separate added amount to the consideration in the transaction. The retail merchant shall collect the tax as an agent for the state." IC 6-2.5-2-1(b). Once the retail merchant collects the sales tax, the merchant has a responsibility to forward that amount to the state. IC 6-2.5-9-3 states that "An

individual who: (1) is an individual retail merchant or is an employee, officer, or member of a corporate or partnership retail merchant; and has a duty to remit state gross retail or use taxes . . . to the department; holds those taxes in trust for the state and is personally liable for the payment of those taxes, plus any penalties and interest attributable to those taxes, to the state."

45 IAC 2.2-6-8(a) provides that "[i]n determining the retail merchants' tax liability for a particular reporting period, the retail merchant shall multiply the retail merchant's total gross retail income from taxable transactions made during the reporting period . . . ." However, in taxpayer's own circumstances, this responsibility is complicated by the fact that there is no sure and certain way of determining taxpayer's "total gross retail income." In those situations in which the merchant has not maintained adequate records, the Department is authorized to make an assessment based upon the best information available. IC 6-8.1-5-1(a) states that "[i]f the department reasonably believes that a person has not reported the proper amount of tax due, the department shall make a proposed assessment of the amount of the unpaid tax on the basis of the best information available to the department."

Having done so, the audit's conclusion – based upon the best information available – is presumed correct. IC 6-8.1-5-1(b) states that "[t]he notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment [was] made."

Taxpayer challenges the audit's conclusions on numerous grounds, but none of these challenges are sufficient to rebut the audit's original determination as to the amount of gross retail sales. The assessments are based upon a methodology which may be subject to criticism – founded or unfounded – but the methodology chosen is entirely reasonable especially given the fact that the audit was faced with so little original documentation upon which to base an alternative conclusion. In addition, taxpayer overlooks the fact it is faced with a problem entirely of its own making. By any stretch of the imagination, taxpayer's record keeping was haphazard. It was taxpayer's initial and primary responsibility to collect sales tax from its customers, forward that tax to the state, and to maintain minimally adequate records substantiating its gross retail sales. Having failed to meet its responsibilities, taxpayer cannot now be heard to complain of the audit's reconstruction of taxpayer business activities. Taxpayer is second-guessing the audit's methodology after taxpayer itself placed the audit in the position of ever having to apply that methodology.

FINDING

Taxpayer's protest is respectfully denied.

II. Abatement of Penalty.

At the time the original audit report was prepared, the Department assessed a 100 percent penalty on the amount of the consequent assessment.

The 100 percent penalty was assessed because of the substantial disparity between the amount of taxes taxpayer received from its customers and the amount of taxes which it forwarded to the Department. IC 6-8.1-10-4(a) states that, "If a person fails to file a return or to make a full tax payment with that return with the fraudulent intent of evading the tax, the person is subject to a penalty. (b) The amount of the penalty imposed for a fraudulent failure described in subsection (a) is one hundred percent (100%) multiplied by: (1) the full amount of the tax, if the person failed to file a return; or (2) the amount of the tax that is not paid, if the person failed to pay the full amount of tax."

The Indiana regulation, 45 IAC 15-5-7(f)(3), states:

> A person who files a return which makes a false representation(s) with knowledge or reckless ignorance of the falsity will be deemed to have filed a fraudulent return. There are five elements to fraud.
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> > (A) Misrepresentation of a material fact: A person must truthfully and correctly report all information required by the Indiana Code and the department's regulations. Any failure to correctly report such information is a misrepresentation of a material fact. Failure to file a return may be a misrepresentation.
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> > (B) Scienter: This is a legal term meaning guilty knowledge or previous knowledge of a state of facts, such as evasion of tax, which it was a person's duty to guard against. A person must have actual knowledge of the responsibility of reporting the information under contention. However, the reckless making of statements without regard to their truth or falsity may serve as an imputation of scienter for purpose of proving fraud.
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> > (C) Deception: Deception operates on the mind of the victim of the fraud. If a person's actions or failure to act causes the department to believe a given set of facts which are not true, the person has deceived the department.
> >
> > (D) Reliance: Reliance also concerns the state of mind of the victim and is generally considered along with deception. If the person's actions, failure to act, or misrepresentations cause the department to rely on these acts to the detriment or injury of the department, the reliance requirement of fraud will be met.
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> > (E) Injury: The fraud instituted upon the department must cause an injury. This can be satisfied simply by the fact that the misrepresentation(s) caused the department not to have collected the money which properly belongs to the state of Indiana.
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> In order to demonstrate fraud, the department is required to prove all of the above elements are present. This must be shown by clear and convincing evidence.

The Department is unable to conclude that the five elements necessary to establish fraud have been proven "by clear and convincing evidence." Instead, the Department finds that the ten-percent negligence penalty required under IC 6-8.1-10-2.1 is appropriate because the underreporting of gross sales resulted from the taxpayer's own negligence. Department regulation, 45 IAC 15-11-2(b), defines negligence as "the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer." Negligence is to "be determined on a case-by-case basis according to the facts and circumstances of each taxpayer." Id. Taxpayer's failure to maintain records sufficient to determine its annual receipts and the amount of sales tax due the state does not constitute the "care, caution, or diligence . . . expected of an ordinary reasonable taxpayer." Id.

FINDING

To the extent that taxpayer has challenge the imposition of the 100 percent fraud penalty, taxpayer's protest is sustained. The imposition of the ten-percent negligence penalty is fully warranted.

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